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ABSTRACT

Key issues for public higher education and reaction of various states to deal with the problems caused by fiscal constraints are addressed. The following four problems are considered: (1) enrollment decline: (2) enrollment fluctuation, regardless of the enrollment trend: (3) changes in the student body composition: and (4) budgetary reductions in state aid. While a state may face more than one of these problems, the strategies for dealing with them are quite different, and they have different implications for institutions. Actions taken by Ohio, Wisconsin, New Jersey, and other states to deal with declining enrollments are briefly outlined. Declining enrollment is defined as a trend occurring over a number of years: enrollment fluctuations are the year-to-year changes in enrollment that occur regardless of whether the trend is up, down, or stable. States have adopted a number of mechanisms to ease the impact on institutions of the financial consequences of assigning state funding directly to the number of students served in the budget year. Alternative solutions include lagged base year, averaged base, and the enrollment corridor concept. It is suggested that basing a funding mechanism on curricular course load or full-time-equivalent student count becomes less acceptable as the difference increases between the number of full-time equivalent students and actual students, and the composition of education and education-related services required by students shifts away from instruction. In addition to considering allocation methods, the difficulty of dealing with budget reduction is addressed. (SW)

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WORKING PAPERS IN EDUCATION FINANCE

Working Paper No. 33

STATE FISCAL CONSTRAINTS IN HIGHER EDUCATION

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INTRODUCTION

All parts of the United States are affected by the fiscal constraints that higher education faces through either the fiscal conservatism that pervades many regions of the country or budgetary restrictions precipitated by declining enrollments. This contraction is a new experience for higher education, and many states in search of ideas for dealing with the problems are inquiring as to what other states are doing in hopes of finding remedies that may be adopted or adapted to address their particular situations.

The Education Commission of the States has received many such inquiries, and the purpose of this report is to identify the nature of key issues for public higher education and to explain what various states are doing to deal with the problems caused by fiscal constraints. The source of most institutions' financial problems are currently related to (1) enrollment decline, (2) enrollment fluctuation, regardless of the enrollment trend, (3) changes in the student body composition, or (4) budgetary reductions in state aid. While a state may face more than one of these problems, the strategies for dealing with them are quite different, and they have different implications for institutions. This paper explains the nature of each of these four problems and discusses what states are doing to deal with the problems and concludes with an observation about the prospects for the financial condition of public higher education in the near future.

I. ISSUE ONE: ENROLLMENT DECLINE

The Problem

All states, some more explicitly and more directly than others, use the number of students served in calculating the amount of state funds to be allocated to higher education. For example, some states use student-faculty ratios as the underlying basis for calculating aid; others agree upon a fixed dollar amount per student. Some states use an incremental approach. A few states make no direct reference to the number of students although even in those states a major change in the level of enrollments would result in a change in the level of funding. The various mechanisms used for allocating state resources to public colleges and universities are coming under scrutiny. The primary reason for this reexamination is that these mechanisms allocate fewer dollars when enrollments decline. While an institution with fewer students should have lower expenditures over the long run, which would make it appropriate for funding to diminish with enrollment reductions, the crux of the issue is determining how rapidly funding should change for a given enrollment change.

In the past, when enrollments were increasing, states with funding formulas tied state appropriations for the operating budget to the number of full-time equivalent students. If enrollments increased by two percent, state aid for instruction, if not for other components of the budget as well, increased by two percent. Similarly, if enrollments dropped by two percent, state aid also dropped by two percent. The implicit assumption underlying this funding strategy was that the cost of educating a student is the same for all students similarly situated. This assumption, while most likely not valid, was not questioned during the 1960s and most of the 1970s when enrollments were increasing. The assumption now, however, is being examined closely because many institutions with enrollment declines feel that costs decline more slowly than enrollments.

Alternative Solutions

Strategies for determining the relationship between changes in costs and changes in enrollments include concepts such as fixed and variable costs and decoupling, although both are used to estimate marginal cost.

The marginal cost is the incremental cost of enrolling one more or one less student. Under most circumstances, the marginal cost is less than the average cost because certain costs are stable or fixed over a wide range of enrollments, such as physical plant operations. Heating costs, for example, have little relation to the number of students as long as the number of students does not change so much as to result in a change in the number of buildings used. Other costs, instruction being a commonly cited example,

are much more variable. If enrollments decrease by, say 10 percent, fewer class sessions have to be scheduled, and that will eventually involve releasing faculty. However, instructional costs are not considered completely variable. An institution pays a faculty member the same salary whether he or she has 22 or 20 students in the class. Only at some reduced level are fewer classes needed. The level at which a reduction is made depends, among other things, on the size of the activity. For instance, if an institution has two sessions of English 101 with 20 students in each session, enrollments would have to drop 50 percent before the two sessions could be consolidated while maintaining the same classroom student-faculty ratio. If, however, the institution has five sessions of 20 students each, enrollments would have to drop only 20 percent before the institution could consolidate the course into four sessions with the same student-faculty ratio. In both cases, moreover, the average operating cost per classroom may actually increase if, as is common practice, the less senior and less costly professor is released and the more senior and more costly professor is retained.

This illustration is used to make two points. One is that classification of costs as either fixed or variable involves making judgments about the educational process of an institution. For example, does changing the student-faculty ratio affect the quality of the outcome? If it does, even for a small change in the ratio, then one could argue that instructional costs are variable only when changes in quality are tolerated.

The second point is that the size of an institution or function within an institution affects the smoothness with which changes can occur. If the activity or function is highly divisible, as is common among lower numbered, core curricular offerings, costs are more easily varied. But upper division, more specialized courses for which there are only enough students to justify offering the course perhaps once a year or every other year become virtually fixed costs until the institution decides to eliminate the course. At that point there is a lump sum reduction of the institution's "fixed" costs, and the mission of the institution is also altered to the extent that that unique course offering contributed to the scope and richness of the institution's education program.

Any effort to categorize costs as fixed or variable and to calculate a marginal cost, besides making these judgments about the education process, must also consider the time frame of the expected change. For example, a gradual, slight enrollment decline of a long duration has different cost implications for an institution than does a more severe decline of short duration. Uncertainty about the steepness, length and duration of a decline makes planning and financing more difficult.

Many costs, considered fixed in the short term, become variable with time. Contractual agreements and fiduciary responsibilities are two types of activities that include obligations that can not

be altered easily in the short term but which, with time, become variable. Other costs may form such an integral part of a program that they are fixed and "vary" only when the activity or function is eliminated. Thus the adage that in the long run all costs are variable is only half the story. Microeconomic theory of fixed and variable costs assumes a consistent product. In education, some costs are variable or become variable over time while others become variable only by changing the nature or quality of the product. The problem of making lumpy cost adjustments, the concern over the possible effects of cost adjustments on institutional quality and mission, and uncertainty about the time frame that should be taken for reviewing cost structures and planning institutional objectives are all involved in dealing with the problem of declining enrollments.

While many states are experiencing fluctuations in enrollments, up and down, these conditions, discussed in the next section, are different from a trend of enrollment decline. Because of demographic conditions and the regional shift of the population, long term enrollment declines are expected to be most severe in the northeast and industrial east of the Great Lakes region. The steps that those states are taking to deal with the decline vary.

Ohio

Ohio is one of the states that has done the most to modify its funding formula. Over the last year and a half, the Board of Regents has assigned several task forces to examine various dimensions of higher education management and finance. Considerable effort has been spent on establishing a funding mechanism that recognizes fixed and variable costs, and the governor's office and the institutions, for the most part, are hopeful that the legislature will fund the next biennial budget for higher education on that basis. The details of the mechanism are as follows.

Within each of five primary expenditure components -- departmental instruction and research, academic support, student services, institutional support, and plant operation and maintenance -- the percentage of costs that are fixed are weighted by the share of the budget they compose. As is commonly found, plant operations and maintenance is the most completely fixed component, and instruction is the least fixed. Within the instructional component Ohio has identified a core portion that should be treated as a fixed cost while the balance of instructional units is treated as variable costs.

The precise budget effect of an enrollment decline on the revenue of an institution will depend on its particular program mix and on the distribution of costs among cost components. Simulations indicate that approximately 70 to 75 percent of a typical state university funding level would be protected if enrollments declined by 40 percent.

Wisconsin

Wisconsin is another state that has given a lot of thought to the expected impact of reduced enrollments on institutions, but their strategy is quite different from Ohio's. Whereas Ohio's effort has been to relate funding formula components more closely to actual costs, Wisconsin has established funding guidelines which, if exceeded, trigger a review and planning process for assessing the appropriateness of consolidating programs and closing facilities.

New Jersey

On an experimental basis, the State Board has recommended that Trenton State College strike a balance between academic quality and decreasing enrollments by adopting a funding mechanism that supports a core requirement for a specified enrollment level. Adjustments to the core would be made in discrete increments as enrollments change by various magnitudes. The experiment will be evaluated with adoption by other institutions in mind.

Other States

Other states, while not as far along in their planning, have established task forces to examine the problem or have developed proposals for consideration by their legislatures. A task force on state-local fiscal relations in Maryland is considering a proposal that implicitly recognizes that all costs do not vary in proportion to the number of full-time equivalent (FTE) students. The proposal provides a flat dollar amount per institution plus a fixed dollar amount per FTE student plus a fixed dollar amount per each part-time student. In Massachusetts, one of the responsibilities of the newly established Board of Regents will be an assessment of enrollment prospects for the state and deliberation of institutional missions. Minnesota has established a statewide blue ribbon task force to study over the next 18 months prospects for declining enrollments and alternatives for a fixed-variable cost methodology for determining state aid.

Designing such formulas to be sensitive to the sources of costs requires extensive data and even then requires making judgments about institutional mission and responsibility. In lieu of undertaking such a major task, as Ohio has done, several states have adopted solutions that serve as convenient substitutes for the more detailed type of analysis. One practice is to decide upon, in a somewhat arbitrary way, some fraction of costs to treat as variable. Florida reduces funding by half the average cost for enrollment declines. California community colleges receive two-thirds of the statewide average revenue per student for increases. For enrollment decreases, the state distinguishes between large (above 3,000 ADA) and small (3,000 or less ADA) community college districts. A large district loses two-thirds of

its district revenue per ADA. A small district loses two-thirds of the statewide average revenue per ADA, giving fiscal protection against the smaller institutions with presumably a higher proportion of fixed costs as well as providing some degree of equalization among districts. Minnesota has adopted a practice that implicitly assumes that the amount of tuition approximates the marginal cost. For the next few years, the legislature has decided not to make any permanent increase in funding and changes in institutional revenues for operating costs will be increased or decreased by the tuition that the institution collects or loses from changes in enrollment.

Some states, such as Connecticut, Illinois and Pennsylvania, do not rely on formulas for funding higher education. While they avoid much of the agony that many formula states are currently going through to revise formulas, the difficult decisions to consolidate or close colleges which will have to be made a few years from now will be no easier for states not using formulas.

II. ISSUE TWO: ENROLLMENT FLUCTUATIONS

The Problem

The issue of enrollment fluctuations is separate from that of declining enrollments. Current use of the term declining enrollments refers to a trend over a number of years. The results of the trend may affect the basic financial soundness of an institution. Enrollment fluctuations, on the other hand, are the year to year changes in enrollment that occur regardless of whether the trend is up, down or stable. Year to year fluctuations may be the result of increases in tuition or student financial aid, changes in labor market conditions, new educational programs at the institution or myriad other unique factors difficult to define or to predict.

For institutions for which the amount of state aid is based on the number of students enrolled, annual enrollment fluctuations can be a source of uncertainty in their funding. Since an institution's financial commitments are seldom made for less than a year, end of the year budget adjustments for final enrollment counts can produce unusual fiscal hardships.

Alternative Solutions

States have adopted a number of mechanisms to ease the impact on institutions of the financial consequences of tieing state funding directly to the number of students served in the budget year.

Lagged Base Year

One technique is to base funding on the enrollment level of an earlier year. Depending upon how promptly enrollments are reported and on the state budget cycle, a gap of one or two years may exist between the year used for determining the enrollment level to be funded and the year of the appropriation. Alabama, for example, requires that funding is based on the most recent year for which there is available data, and, it results in a two-year delay. Although funding is directly tied to the number of students, the delay allows an institution to learn what enrollment level will be funded in advance of the actual funding. A disadvantage of this technique is that, if there is an upward trend in enrollments, funding is based on a smaller number of students than actually enrolled. Of course, if the practice is maintained when enrollments decline, an institution is funded at a higher level than would be the case if funding were based on current year enrollment.

Averaged Base

Another approach to ease the consequences for an institution of fluctuating enrollments is to base funding on the average enrollments over more than one year. Wisconsin, for instance,

bases aid to the University System on a five-year moving average of enrollments that includes the current year, the past two years and projected enrollments for the next two years. To lessen the effect of enrollment fluctuations at the institutional level, the University System makes a subjective assessment of the nature of the enrollment variation and where an enrollment shortfall appears temporary will adjust its allocation to the institution to an expected level of enrollment over several years.

More common is the situation in New Jersey. A funding provision for senior public institutions allows the financial impact of any annual enrollment decline to be spread over two years. The provision reduces funding for instructional faculty by only 50 percent of what would occur if the full effect were borne in the year of the enrollment reduction.

Enrollment Corridor Concept

A third technique is to allow enrollments to fluctuate within a certain range without requiring any budget adjustment. This approach, referred to as corridor funding, is gaining appeal. Some of the states using corridor funding or considering its use include Alabama, California, Kansas, and Virginia. The width of the corridor is most commonly two percent of enrollment, but in Virginia, which places particular emphasis on institutions making accurate enrollment projections, the governor may require tuition and fee revenue generated by enrollments that exceed projected enrollments by more than one percent placed in the general fund. Texas, in contrast, tolerates larger variations. Although Texas does not have an explicit corridor funding approach, the legislature, once it has made its appropriation, is reluctant to make budget changes unless the unexpected enrollment variation is large.

The enrollment corridor funding concept has a lot to recommend it. Although it is sometimes used to cushion enrollment declines, the primary purpose of the concept is to buffer institutional revenues against year to year enrollment fluctuations, regardless of the enrollment trend. It avoids an institution having a chunk of its budget withheld in the same fiscal year to adjust for a miscalculation in estimating enrollments.

A commonly cited remedy to the problem of estimating enrollments is to obtain greater precision in making enrollment projections. If projections were more accurate, then end of the year financial adjustments would be smaller. However, allocating more resources to making more accurate enrollment projections probably represents misplaced priorities. Current year to year projections are generally accurate within three to five percent. Furthermore, the estimates do not require extensive data or elaborate modeling. To improve the accuracy of the projections to within one or two percent would require more detailed, extensive data. It does not seem that the large increase in cost that would be required to

perfect projections justifies the slight increase in accuracy, particularly when a number of good alternatives such as those discussed above exist.

Over several years, deviations of actual enrollment levels from enrollment projections probably cancel each other. California, for example, which uses a two percent enrollment corridor, has found that over a nine-year period the average deviation at the University of California was 0.1 percent. Among its state university and colleges the nine-year average was less than two percent.*

*California Postsecondary Education Commission. "State Budget Formulas for Declining Enrollments in California's Public Segments of Postsecondary Education," Policy Development Committee, March 17, 1980.

III. ISSUE THREE: FINANCIAL PROBLEMS ARISING FROM A SHIFT IN THE COMPOSITION OF THE STUDENT BODY

The Full-Time Equivalent - Headcount Gap

During the last 10 to 15 years there has been a substantial increase in the number of nontraditional students. Adults as well as educationally, socially and economically disadvantaged individuals constitute a growing proportion of enrollments. Coincident with the different attributes of these students is a frequent preference for part-time rather than full-time enrollment. This shift in the distribution of enrollment status results in different costs for an institution.

Several decades ago when funding formulas were first developed nearly all students attended on a full-time basis and their education interests and needs were fairly homogeneous. Consequently, a calculated average cost represented all students fairly well. Use of the full-time equivalent student as the unit of measure for funding worked quite well. As more students enrolled on a part-time basis, though, student workloads became less uniform, and a gap developed between the number of headcount students and the number of full-time equivalent students. With funding frequently tied to the latter, institutions found that revenues were not keeping pace with the number of students served. For example, institutions spend virtually the same amount of time registering or providing health insurance for a half-time student as for a full-time student, although the half-time student may generate only half as much state aid for the institution as a full-time student if the funding mechanism is based strictly on full-time equivalent instructional workload.

The basic flaw of the FTE funding approach is that it is too one dimensional, relating all budget items to the course workload of the student. It overlooks other important dimensions, such as student services for which need is more closely related to the number of students than to the full-time equivalent number of students. This disparity is aggravated by the increasing enrollment in recent years of disadvantaged students who have a greater than average need for student services such as counseling, information about student financial aid, child care and job placement. In sum, basing a funding mechanism on curricular course load or FTE student count becomes less acceptable as (1) the difference increases between the number of full-time equivalent students and actual students and (2) the composition of education and education related services required by students shifts away from instruction -- the dominant unit of measure for funding purposes.

It should be pointed out that this problem is one that has developed independently of the problem of enrollment decline. Many states have adopted formulas that use headcount students for certain activities, but the scrutiny given to formulas because of

declining enrollments is increased by the growing variation in the profile of education needs of students. Without going into a lengthy discussion of the components of funding formulas, which has been done in detail by Francis Gross* and others, suffice it to say that the most popular approach today among states using formulas is to base the instructional component of the budget on some measure of courseload. Funding for student support services is often based on headcount students, and several states, such as Maryland and Colorado, which currently use only full-time equivalent students are considering using headcount students for portions of the formula calculations.

Changes in the Distribution of Instructional Needs

The second financial problem raised by the increasing share of nontraditional students is that many of the students enroll in high cost programs. While dominant among nontraditional students, this phenomenon is also found among conventional students. Many institutions, community colleges in particular, find average operating costs rising (even when course offerings are not increased and when adjustments are made for inflation) because of a trend in preference for vocational and technical programs which are high cost programs. Developmental courses, remedial programs and special courses, such as English as a second language, have a similar effect on costs and arise largely because of the growing number of nontraditional students enrolling in these courses.

A common method for dealing with these changes in costs due to shifts in enrollments among programs is to establish in the funding students frequently mechanism separate cost categories for various programs. In this way, an institution does not bear an unusual financial burden if students enroll in high cost courses nor does it reap unearned revenue if there is a shift of enrollment toward lower cost courses.

The most common distinctions are among lower, upper and graduate division programs at four-year institutions and between vocational and nonvocational programs at community colleges, although the differentiation can be extensive. Texas, for example, uses several dozen instructional categories, and South Carolina uses over 100 codes for funding categories (derived from the Higher Education General Information Survey).

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*Gross, Francis M. "A Comparative Analysis of the Existing Budget Formulas used for Justifying Budget Requests or Allocating Funds for the Operating Expenses of State-supported Colleges and Universities." Ed.D. dissertation, University of Tennessee, 1973.

A variation of this solution is to fund the student rather than the program. For example, New York has a unit cost formula that provides a fixed dollar amount per FTE student plus, under certain circumstances, an additional dollar amount for each disadvantaged student. The extra funding for the disadvantaged student is comparable in outcome to what other states do to compensate for the higher cost programs that disadvantaged students frequently enroll in. Recognition in state aid funding mechanisms of special programs or students with special needs is also achieved through set asides. Maryland, in a proposal it is considering for alleviating the full-time equivalent - headcount gap problem, is also considering allocating $800,000 for remedial education. The funds would be prorated among institutions based on the number of remedial students.

In Illinois, the Community College Board identified the need for additional funding for adult basic education and general education courses. The Board of Higher Education accepted the analytical results but felt that the issue should be handled by reallocating resources and consequently set aside $2 million for additional instruction in these subjects and reduced all other instructional categories by a proportionate amount. Illinois also provides $5 million in disadvantaged student grants, part of which is allocated among campuses on an equal basis while the balance of funds is allocated in proportion to student credit hours in these subjects.

IV. BUDGETARY CONSTRAINTS

The first three sections discussed ways for determining appropriations so that they match more closely the sources of expenditures. While such adjustments are improvements in allocating resources, no amount of manipulation of the allocation mechanism compensates for a reduction of resources to be allocated. There are few satisfactory solutions for dealing with budget reductions. Program review, for example, is a continuous interest of an institution but becomes a more pressing concern when budgets are tight, and yet there is a limit to what paring can or should be done as a result of reviewing programs. Today, the problem of budget constraints is widespread. Western and southern states are often thought to be in relatively good positions because of their population growth and anticipated stable or continued growth in enrollments. However, these states also have financial problems. In the November election, six of the eight states with tax or spending limitation referenda were western states. Arizona, Nevada, Oregon, South Dakota and Utah had voter initiatives limiting property taxes to one percent of market values. Although these measures did not pass, strong conservative sentiment is still present.

Although the voter initiatives were primarily in the western states, many other states have had legislative action limiting higher education expenditures, in many cases, because of shortfalls in state revenues or escalating expenditures. For example, Connecticut has been caught with rising costs of mandated public services plus inflation and falling revenues which has led to budget rescissions by the governor. Proposition 2 1/2 in Massachusetts will affect higher education indirectly because some of the states's revenue will be used to cover funding shortages at the local level caused by Proposition 2 1/2. Maryland, Michigan, New Jersey, Ohio and other states are simply caught in the inflation-recession squeeze that reduces state revenues available for higher education.

The full impact of a tax or spending limitation is difficult to assess without knowing the details of the provision. A common approach at the local level is to limit increases in property taxes to a fixed percentage of market value. In this way, property tax revenue increases only as property values do. At the state level, a common constraint is to limit increases in state spending to a fixed percentage of personal income. This strategy allows the public sector to grow but not to become a larger share of overall state economic activity. The "advantage" to these types of taxing and spending limitations is that the public sector grows or contracts along with the economy of the state. While this "advantage" may be debatable, it is more apparent when compared with an absolute, inflexible spending limitation.

Colorado is a good case in point. In 1977 the legislature passed a law limiting annual increases in total state spending to seven

percent. With a growing economy and population, the limitation will result in a reduction of the public sector. The seven percent increase covers neither inflationary increases in costs nor expanding service needs for the growing population. Subsequent to passage of this provision, the legislature also imposed the same spending limitation upon the counties but exempted new property from the seven percent limitation for the year that the property is added to the tax rolls.

The impact on Colorado higher education is quite different for different institutions. First, higher education must compete for state aid along with all other public services. If higher education succeeds in obtaining a budget increase of more than seven percent, then some other agency gets less than seven percent. All of the four-year institutions are caught in this competition. For the community colleges, the situation is different. Colorado has a dual community college system -- one system of fully state-funded community colleges and another of local district community colleges that assess local property taxes and receive flat grant aid from the state. The state community colleges are in a situation similar to the four-year institutions, but the revenue of the local district community colleges depends upon the prosperity of the district. The western part of the state is participating fully in the energy development boom and each year new construction adds millions of dollars to property tax rolls thereby providing a source of revenue outside the seven percent limitation. In short, the effects of different types of tax and spending limitations need to be examined on a case by case basis because of many unique provisions that may exist and which have profound implications for a state.

Although both declining enrollments and fiscal conservatism tends to restrict higher education funding, state responses will be quite different. The worst case, of course, is to have both declining enrollments and declining state revenues; there are few tradeoffs available. However, for a state with increasing or stable enrollments and a reduction in state revenue, there are options, such as increasing admission standards or student charges, that can alleviate the problem of reduced state revenues for higher education institutions.

V. A FINAL COMMENT

While some states face more dire circumstances than others, no state seems to be without some financial problem, but the severity of conditions seems most grave in the east and midwest. While all institutions are aware of the pending enrollment decline anticipated for the 1980s, many policymakers are concerned that institutions feel that they are unique and that they will not be affected as severely as others. The current year enrollment increase has added to this sense of infallibility. The current buoying of enrollments, however, is due to the phase of the business cycle we are in. High unemployment is having a positive influence on enrollments.

When unemployment declines, enrollments also will decline. Unfortunately, the coincidence of high unemployment with the peaking of the number of conventional collegiate aged youths is helping to keep enrollments stable rather than allowing them to turn downward gradually. When the unemployment rate drops, the college attendance rate will drop, compounding the underlying downward trend in enrollments caused by smaller cohorts of 18-year-olds. At that time there will be no doubt of the reality of decline.

For many states and institutions it will be imperative for them to deal with changes in enrollment, changes in student characteristics and reductions in revenue. No one welcomes retrenchment, but it is inevitable for many institutions. Understanding the nature of the issue discussed in this paper and understanding their relationships to and implications for financing higher education helps to make the best of an unpleasant situation. The Education Commission of the States plans to work on aspects of these issues over the next couple of years in order to assist the states.

WORKING PAPERS IN EDUCATION FINANCE

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